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IN THE

Supreme Court of the United States

October Term, 1971

No. 71-1665

UNITED STATES OF AMERICA,

Petitioner,

v.

DOUGLAS B. CARTWRIGHT, as Executor of the ESTATE OF ETHEL B. BENNETT,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

RALPH J. GREGG, on behalf of the Respondent, submits this brief in opposition to a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

Questions Presented

The question as stated in the petition (whether the regulation is valid) is not the basic issue. The basic question is the "value" of the mutual fund shares owned by Ethel B. Bennett within the meaning of the word "value" in

§ 2031 of the Internal Revenue Code. The regulation is only the Commissioner's own opinion, understandably biased, of how "value" should be determined under that section. It does not preclude the Court from considering the real issues in dispute, which are:

1. Was the fair market value of the mutual funds owned by Ethel B. Bennett at the time of her death:

(a) The $124,399.87 the executor would have received for them if he had sold them on that date (*i.e.* the bid or redemption price) or

(b) The $133,325.14 the executor would have had to pay to purchase the same number of additional shares on that date (*i.e.* the replacement cost or asked price)?

2. Is the difference (the $8,925.27 that would have to be paid to the broker as a commisison on the purchase of the additional shares) an asset of her estate subject to the estate tax?

Once these questions have been answered, the Court will be in a position to determine if the regulation is a fair and reasonable interpretation of the statute or an arbitrary and unreasonable one.

Statement of the Case

The statement of the case as it appears in the government's petition is a generalization about investment companies. Some of the generalizations are unobjectionable, but some are incomplete, misleading or inaccurate with reference to the particular facts of this case. The correct facts developed both through stipulations, expert testimony and exhibits are these:

1. The statement that "a mutual fund is an organization which sells shares in itself" is not entirely accurate. Only a "no load" fund can be said to sell shares in itself, *i.e.*, it uses no marketing agent or broker to sell its shares to the public. Investors Stock Fund, Inc., Investors Mutual, Inc. and Investors Selective Fund, Inc. are "load" funds. Their shares are distributed by Investors Diversified Services, Inc. (hereinafter referred to as IDS) which is not an investment company, pursuant to a distribution agreement with the investment companies. IDS receives, in full payment for its services as distributor of these shares, a distribution fee equal to the amount by which the public offering price exceeds net asset value. The remainder of the purchase price is the "net asset value" which is received by the investment company. From its fee, IDS pays commissions to its sales representatives and other expenses incident to or in connection with the distribution and sales of shares. IDS also provides investment advisory and management services for its affiliated investment companies. No part of the "load" or "distribution fee" is for investment advisory or management services. Instead, by separate contract, the investment companies pay IDS a management fee out of the income otherwise distributable to the shareholders as dividends.

2. The statement that open-end investment companies are "required by law" to redeem outstanding shares is inaccurate. The proof in this case was that Investors Mutual Funds, Inc., Investors Stock Funds, Inc. and Investors Selective Fund, Inc. were obligated by contract, not by law, to redeem their shares. Before an investment company can register with the Securities and Exchange Commission as either an "open-end" or a "closed-end" investment company (which does not redeem its shares) it must

elect which it chooses to be. This election is made in its certificate of incorporation which must predate the SEC registration. The certificate of incorporation of each of these investment companies gives each registered shareholder the right to require it to redeem its shares at any time at their "net asset value" and without charge. The obligation is contractual. The prospectus of each of these companies correctly states, therefore, that "by express provision in the Company's certificate of incorporation, the registered holder of shares of the company has the right to require the company to redeem his shares". The evidence in this case was that these investment companies consider it advantageous for sound and realistic business reasons to willingly offer and to stand ready, willing and able at all times to redeem any shares presented to them. The promise of immediate and guaranteed liquidity is an extremely important and integral part of the making of a sale. Investment companies compete effectively with securities listed on the exchanges by offering and promising to redeem shares "at the market" and to pay for them in cash upon receipt of the certificate and in no event later than seven days from the receipt of the tender.

3. The explanation of the bid and asked prices would be more understandable if stated as follows:

(a) The public offering price is the "net asset value, ordinarily determined daily, plus a maximum sales charge of 8% of the public offering price" (lesser commission percentages apply for quantity sales). This is generally described as the "asked" price in the financial pages.

(b) The "net asset value" is computed daily as of the close of trading on the New York Stock Exchange when the exact value of the entire portfolio of securities can be accurately determined. The total assets are valued and the

total outstanding liabilities are subtracted. The resulting net worth is divided by the number of outstanding shares to determine the "net asset value" per share. This is generally described as the "bid" price in the financial pages.

(c) The difference between the bid and asked prices quoted daily in the paper is the commission or "load" that the purchaser must pay to the broker to acquire shares having a net asset value equal to the bid price. If a mutual fund company decides to market its own shares without a sales charge, i.e. if a "load" fund becomes a "no load" fund, the value of the shares is then publicly quoted at net asset value in both columns for the purpose of both sale and redemption.

4. The statement in the petition that "in the normal course of business, all transactions for purchase or sale of shares of open-end investment companies, including the three herein, take place between the investor and the issuing company whose shares are involved" is misleading. Load funds market their shares through brokers, securities dealers, underwriters or other distributing or marketing agents. The distributor of the shares involved here is Investors Diversified Services, Inc. Investors Mutual, Inc. Investors Stock Funds, Inc. and Investors Selective Fund, Inc. pay no part of the brokers' commissions. To do so would dilute the fund belonging to the shareholders. The entire commission is paid by the purchaser. These mutual fund companies receive only the net asset value. To receive more would unduly enrich previous shareholders. By agreement with its marketing agent, shareholders are permitted to reinvest their income and capital gains distributions in additional shares at their net asset value and without any commission or load to IDS.

5. It is not correct that the maximum sales load of the funds "involved here" ranged between 7% and 8% and a minimum of 1%. The holdings of Ethel B. Bennett in each of the three funds were, in dollar amounts, too small to qualify for quantity discounts lower than 6%.

6. The government's statement omits the fact that although there are no restrictions on the transferability of shares of these investment companies, the shareholders dispose of them by requesting the company to redeem them, there being no other market for these shares. The redemption price is the "net asset value" calculated as of the close of business on the day of receipt of the surrendered stock certificates or (if the shares are held by the investment company for the account of the owner) on receipt of the request to redeem. There is no charge for redemption.

7. The government's statement of facts omits any reference to additional facts which are distinctive to this case and which are relevant to the issues, as follows:

(a) Ethel B. Bennett acquired none of her shares by purchase at the "asked" price. She acquired most of them from the estate of her husband, Arthur Y. Bennett, who died on October 1, 1962. These shares were valued in his estate at their net asset value or redemption price and this valuation was accepted on the audit of his estate tax return. She acquired the rest by reinvesting her dividends and capital gains distributions in additional shares at their "net asset value" or bid price.[1]

(b) The beneficiaries of the Estate of Ethel B. Bennett have sold some of the shares she owned and realized only their net asset value, as follows:

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[1] The right to reinvest dividends and capital gains is extended to any shareholder whether he paid the asked price or not.

(i) All 2,568.422 shares of Investors Mutual, Inc. were distributed to Douglas B. Cartwright and Carolyn Tenney as trustees for the benefit of Dorothy B. Cartwright. The trustees tendered these shares for redemption on February 19, 1969, and received payment for them at their "net asset value" or bid price.

(ii) 969.376 out of 2269.376 shares of Investors Stock Fund, Inc. were distributed to the same trustees who also tendered them for redemption on February 19, 1969, and received payment for them at their "net asset value" or bid price.

(iii) The remaining 1260 shares of Investors Stock Fund, Inc. were distributed outright to Dorothy B. Cartwright. She gave 430 of them to Douglas B. Cartwright. He requested Investors Stock Fund, Inc. to redeem his 430 shares on November 7, 1966, and they were redeemed at their "net asset value" or bid price.

As of the date of the trial, Mrs. Bennett's heirs still owned 860 shares of Investors Stock Fund, Inc., 1,869.159 shares of Investors Selective Fund, Inc. and 2,067.531 shares of Investors Mutual, Inc.

Reasons for Denying the Writ

Many millions of mutual fund shares have been valued for estate tax purposes since the enactment of the Investment Companies Act in 1940.

For upwards of 20 years until about 1961, the Internal Revenue Service accepted their valuation at net asset value or bid price (the price at which the investment companies contractually agree to redeem them whenever offered for redemption).

This was completely consistent with long accepted concepts of valuation for estate tax purposes, *i.e.*, that the estate tax was to be imposed on the amount the estate could reasonably be expected to realize from the decedent's property. Witness the "blockage" rule, the acceptance of the contract price specified in arms-length corporate buy-sell agreements as determinative of value to the estate, the valuation of an automobile at what the widow could reasonably expect to sell it for, the valuation of furniture and household goods at prices an auctioneer, antique dealer or other qualified appraiser believed the estate could realize from their sale, etc.

But, in about 1961, the Treasury Department conceived the idea of increasing the revenue significantly by valuing mutual fund shares at the asked price (the price the executor would have to pay to purchase as many additional shares as the estate already owned).

The difference between the bid and asked prices quoted in the papers is the commission that goes to the broker for bringing the seller and the buyer together. This sales charge, commonly referred to as a "load", is exactly like the commission charged by Merrill, Lynch or Goodbody & Co. for handling the purchase of shares of General Motors. It is not an element of value—and is not included in the published price of General Motors stock.

The Treasury has always agreed that the broker's commission on the purchase of listed and over-the-counter securities has absolutely no bearing on the value of the listed stocks owned by the estate. Nevertheless, it began to insist on including the broker's commissions in the value of mutual fund shares.

Hundreds and perhaps thousands of protests were registered in District and Regional offices and some of them reached the litigation stages in both the Tax Court and as claims for refund in the District Courts where, by law, the Department of Justice represents the Treasury.

The Department of Justice reacted by ordering the Internal Revenue Service to make refunds to the executors,[2] agreeing that the fair market value for estate tax purposes was the amount the executors could get for the shares and not what they would have to pay to purchase as many more through a broker.

The Treasury Department reacted in turn by issuing Reg. Sec. 20.2031-8 (b) on October 11, 1963, to substitute a new issue for taxpayers to overcome, *i. e.*, the burden of proving that the Commissioner was completely unreasonable, arbitrary and capricious in the exercise of his power to issue regulations.

The new rule would have stuck out like a sore thumb in the regulations dealing with the valuation of stocks and bonds (20.2031-2 (a)-(h)). So the Commissioner inserted it in the regulation dealing with the valuation of single premium life insurance policies (20.2031-8) at so-called replacement cost for whatever mileage this would give him on the issue of reasonableness. It was a clever maneuver because it pushed the valuation issue, on which the taxpayer was clearly right, into the background.

Then, to be sure no court would rule in favor of a taxpayer on the valuation issue before it could use its "power to make regulations which the courts must uphold unless

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[2] *Estate of Addie G. Baldwin v. United States*, USDC, WDNY (1/14/63); *Estate of Ethel Louise Stern v. United States*, USDC, WDNY ((5/28/63).

completely unreasonable" issue, the Treasury issued Rev. Proc. 64-18, 1964-1 CB (Part 1) 681, instructing all personnel to refund any taxes collected on the sales charge or "load" in estates of persons dying before October 11, 1963, thereby clearing all the dockets in the Tax Court and the District Courts.

This maneuver enabled the Treasury Department to select a case involving a decedent dying after October 11, 1963, and to have Treasury Department attorneys use the regulation as the decisive issue in the Tax Court (*Wells v. Commissioner*, 50 TC 871, where the Court held, in substance, that the taxpayer had not carried his burden of proving that the Commissioner was completely unreasonable, arbitrary and capricious).

Since the Department of Justice is obliged by statute to represent the Treasury in the Federal Courts, it thus became obliged to defend a theory of valuation it had previously opposed. It succeeded in getting the Sixth Circuit Court of Appeals to affirm the *Wells* case in *Ruehlmann v. Commissioner*, 418 F. 2d 1302 (1969), the rationale of which was copied by the Seventh Circuit Court of Appeals in a gift tax case, *Howell v. United States*, 414 F. 2d 45 (1969).

The *Wells* case shocked the financial community which knows that the 8% sales charge or "load" goes to the marketing agent and that the moment the purchase price is paid, all the owner, alive or dead, can get from anybody for his shares, is the net asset value. It dumbfounded the investment companies whose sales literature, governed by SEC regulations, makes a special point of the fact that for every $10,000.00 invested with them, the purchaser will have shares worth $9,200.00. It made brokers

and investors alike (and businessmen generally) wonder how the Courts could be so oblivious to the business facts.

Intrigued with the revenue producing potential of the so-called "replacement cost" theory, the Commissioner, on June 7, 1965, amended Reg. Sec. 20.2031-1 (b) to add a new concept of valuation for automobiles, household furniture and furnishings, personal effects and property generally. Gone was the idea that the fair market value of the decedent's 1970 Electra is the $3,000.00 the widow could get for her deceased husband's car from a willing buyer. In its place was the newer concept that the value of the decedent's 1970 Electra is the $3,600.00 retail price the widow would have to pay to purchase somebody else's reconditioned, warranteed 1970 Electra from a retail dealer.[3]

The Internal Revenue Service has not risked a lawsuit as to the validity of this regulation, apparently preferring to first "nail down" its new replacement cost theory with the more sophisticated arguments it can use to cloud the issues in the mutual fund litigation.

None of these regulations were "needful" after upwards of 40 years of undisputed acceptance of the Commissioner's method of determining the value of automobiles, boats, pianos, silverware, jewelry, etc. for estate tax purposes under Reg. Sec. 20.2031-6 and over 20 years of non-controversial valuation of mutual funds under Reg. Sec. 20.2031-2.

The Commissioner's new regulations were clearly intended to legislate the method which would produce the

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[3] See example used by the Commissioner in his regulation to illustrate his new "retail price" theory of valuing an auto; and how he attempts to tie it to the coattails of the "replacement cost" theory of Reg. Sec. 20.2031-8.

greatest revenue without regard to well established concepts of fair market value.

The mutual fund regulation was not the product of a considered judgment. It was an arbitrary expedient to put the entire weight of the government on the taxpayer; to multiply his burden of proof and to halve his chances of getting judicial relief, knowing full well that millions of small taxpayers would have to "knuckle under" because they could not afford to litigate the issue. This approach to the collection of revenues does little to enhance the esteem of the government in the eyes of the taxpayer.

The amount involved here is only $2,699.41. The decision in favor of the taxpayer in the District Court was obviously correct, well reasoned and consistent with the estate tax statutes enacted by Congress. Nevertheless, the government dragged this taxpayer to a Circuit Court of Appeals which, again, confirmed his right to a refund.

The decision in favor of the taxpayer in *Robert C. Davis v. United States*, 306 F. Supp. 949, affirmed in the Ninth Circuit on May 23, 1972 (and involving a refund claim of $604.84) contains equally convincing reasons why the Treasury is wrong and should abandon its unreasonable position and withdraw its regulations.

Nevertheless, the government proposes to make this taxpayer defend his rights in the Supreme Court of the United States when it is abundantly clear that the Commissioner should have sought the approval of Congress for such revolutionary changes in the estate tax laws and should now correct his own error without further harassment of taxpayers on the transparent pretext that mutual fund shares are the closest of kin to single premium life insurance policies and diamond rings subject to wartime luxury excise taxes.

Apropos of the situation here is the commentary of Mr. Justice Douglas in *Commissioner v. Lester*, 366 U. S. 299, 311, 312:

> "The revenue laws have become so complicated and intricate that I think the government in moving against this citizen should also turn square corners . . . resort to litigation, rather than to Congress for a change in the law is too often the temptation of government which has a longer purse and more endurance than any taxpayer."

Certiorari should be denied.

Respectfully submitted,

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